

**NORTHERN ILLINOIS GAS COMPANY
D/B/A NICOR GAS COMPANY
REBUTTAL TESTIMONY OF
ALBERT E. HARMS
ILLINOIS COMMERCE COMMISSION
DOCKET NO. 01-0439**

**NICOR GAS
GROUP EXHIBIT 5**

OFFICIAL FILE

I.C.C. DOCKET NO. 01-0439

Nicor Group Exhibit No. 5

Witness _____

Date 11/17/02 Reporter TR

1 Q. Please state your name and business address.

2 A. Albert E. Harms, 1844 Ferry Road, Naperville, Illinois 60563-9600.

3 Q. Are you the same Albert E. Harms that filed direct testimony in this case?

4 A. Yes.

5 Q. What is the purpose of your rebuttal testimony?

6 A. The purpose of my rebuttal testimony is to address certain issues raised by Staff
7 witnesses Anderson and Iannello concerning the Company's request for a change
8 in accounting treatment applicable to certain revenues generated from certain off-
9 system storage services and the allocation of joint costs that would be a direct
10 result of Nicor Gas expanding its Troy Grove storage facilities.

11 Q. What issues raised by Staff will you address?

12 A. There are three issues that I will address. First, I will discuss the cost allocation
13 procedures the Company proposes to implement if the Commission approves its
14 request to account for revenues and costs below the line. Second, I will discuss
15 the topic of "displacement" as it applies to the Troy Grove storage expansion
16 project. Finally, I will address Mr. Iannello's concern that storage services
17 provided to third parties as a result of the Troy Grove expansion project could
18 potentially be subsidized by ratepayers.

I. Cost Allocation Procedures

Q. Mr. Anderson describes the physical flow of gas associated with Nicor Gas' proposed storage service and indicates that the proposed storage service will use existing facilities in providing the service. Do you agree?

A. Yes. As Mr. Anderson explains, the Company is not proposing to create entirely new storage facilities to provide only this service. Use of existing facilities, in conjunction with new facilities, will be necessary to offer the new service. Moreover, as Mr. Upshaw has explained, the new facilities will enhance existing facilities and also help to provide service to utility customers.

Q. Mr. Anderson indicates that it is impossible to accurately measure the incremental costs associated with using existing facilities for the new service. Do you agree?

A. I agree that Mr. Anderson is literally correct, because there is no way to precisely measure incremental costs associated with using existing storage facilities. However, this is not unique to this project. In setting utility rates by customer class, it is standard procedure to allocate common, or joint, costs across customer classes. This is why, in this case, the Company proposes to allocate certain joint costs away from Commission-regulated utility service to the proposed Federal Energy Regulatory Commission-regulated storage service.

Q. Please describe how the Company proposes to allocate storage costs associated with the Troy Grove expansion.

A. For costs that can be directly tied to the project, such as operating and maintenance expenses of the new compressor and dehydration tower, the Company proposes to directly transfer those costs below the line. For remaining

1 joint costs, the Company proposes to base its allocation on the percentage
2 increase in expanded top gas capacity that would be added to the Troy Grove field
3 as a result of the expansion project, approximately 10 percent (5 Bcf / 48.1 Bcf).

4 Q. Has Staff proposed any other cost allocation method?

5 A. No.

6 Q. Has the Commission established rules for allocating costs between utility and
7 non-utility functions?

8 A. Yes. As noted in my direct testimony, the Company's proposed accounting
9 treatment is consistent with 83 Illinois Administrative Code Part 506, which
10 provides for cost allocation of shared facilities that are used to provide both utility
11 and non-utility services. Since it has established these cost allocation rules, it
12 seems reasonable to conclude that the Commission contemplated that utilities
13 would use shared facilities to provide both utility and non-utility services. In my
14 opinion, the proposed Troy Grove expansion is such a project.

15 Q. Have you prepared an exhibit that provides an example of the Company's
16 proposed cost allocation method?

17 A. Yes. Using actual 2000 cost data, Rebuttal Exhibit AEH-1 shows the allocation
18 of joint costs that would be applied if the Commission approves the Company's
19 proposal. As noted in Staff's direct testimony, about \$377,300 of annual
20 operating and maintenance costs, depreciation and return on rate base related to
21 the shared facilities would be allocated below the line. It would be the
22 Company's responsibility to attempt to recover these allocated costs through
23 marketing of the proposed service. In addition, the Company estimates that direct

1 annual depreciation and operating and maintenance expenses related to new
2 investment at Troy Grove would be about \$ 1.2 million.

3 Q. Do you agree with Mr. Anderson and Mr. Iannello that the benefit to ratepayers
4 from this project would be only the \$377,300 related to the allocation of joint
5 operating and maintenance costs?

6 A. No. As I have shown on Rebuttal Exhibit AEH-2, I believe the benefits to
7 ratepayers from this project would approximate \$928,100. This amount includes
8 the \$377,300 Mr. Iannello and Mr. Anderson agree with, plus depreciation and
9 rate of return on an estimated \$4 million of capital overheads that would be
10 allocated to the Troy Grove project. These costs would have most likely been
11 allocated to other capital projects that would be included in rate base. Therefore,
12 if the proposed expansion goes forward, the Company expects its rate base will be
13 about \$4 million lower in Nicor Gas' next general rate case. Ratepayers would be
14 relieved of providing depreciation and a rate of return, totaling about \$550,800,
15 on this amount of rate base.

16 Q. How would the proposed cost allocation method directly benefit customers?

17 A. As a direct benefit, the revenue requirements that would normally be paid by
18 ratepayers would be reduced by about \$1 million. While this reduction would
19 help to delay the need for a future general rate increase, there would be no
20 immediate impact on customer rates. Therefore, in the interest of compromise,
21 Nicor Gas would be willing to annually flow \$1 million through the Company's
22 purchased gas adjustment clause to provide an immediate financial benefit to
23 customers. At the conclusion of the Company's next general rate case, this flow-

1 through would end and 10 percent of the then current costs, consistent with the
2 Company's proposal, as shown on Rebuttal Exhibit AEH-1, would be allocated
3 below the line and reflected as a reduction in the otherwise effective new base
4 rates.

5 Q. Have you prepared an example comparing the Company's original proposal to the
6 revised proposal?

7 A. Yes. Rebuttal Exhibit AEH-2 shows that Nicor Gas' initial proposal would
8 benefit ratepayers by reducing revenue requirements at the time of the next
9 general rate case by \$928,100. The Company's alternative proposal is to credit \$1
10 million to the PGA so that customers get an immediate financial benefit from the
11 Troy Grove project.

12 **II. Gas Supply Operations via Displacement**

13 Q. Please define the term "displacement" as it relates to the storage services that
14 would be provided to third parties as a result of expanding the Troy Grove storage
15 field.

16 A. Displacement is the switching of gas supplies from being delivered into storage to
17 being distributed directly to customers, or vice-versa. For example, assume that
18 the Company purchases 1,000 Mcf of gas to be received over the facilities of
19 Natural Gas Pipeline Company of America, ("NGPL"). That quantity of gas
20 could be delivered into storage at Troy Grove or delivered directly to end-users.
21 For a particular day, the Company could plan to inject 800 Mcf of gas into storage
22 and deliver 200 Mcf of gas directly to end users. However, if a customer who had
23 purchased off-system storage service wanted to put 200 Mcf of gas into storage at

1 Troy Grove, Nicor Gas could inject all 1,000 Mcf of its gas purchases via NGPL
2 into Troy Grove and deliver the storage customer's 200 Mcf of gas, which may
3 have been delivered through a different pipeline, directly to end-users. In this
4 example, Nicor Gas would not have changed the amount of gas it purchased over
5 either pipeline, as the only variable is which pipeline gas is injected into storage
6 and which pipeline gas is delivered directly to end users. Therefore,
7 displacement, as that term is used by the Company and as the proposed
8 expansion-related storage service would operate, would have no impact on Nicor
9 Gas' gas supply costs.

10 Q. Have you prepared an exhibit illustrating this example that is similar to the
11 illustration contained in Mr. Iannello's direct testimony?

12 A. Yes. Rebuttal Exhibit AEH-3 is essentially the same as Mr. Iannello's
13 illustration, with the exception that Company gas supply purchases from the three
14 pipelines are unaltered from one scenario to the next. In addition, I have added a
15 section that shows the physical flow of the gas deliveries. Mr. Iannello's
16 illustration does not show the physical flow and, thus, does not provide a
17 complete picture of all the activity that would take place from an operational
18 perspective. Rebuttal Exhibit AEH-3 clearly shows that providing the proposed
19 off-system storage service in the manner proposed by the Company, including use
20 of displacement, could not and would not increase Nicor Gas' gas supply costs.

21 Q. Is Mr. Iannello's illustration unique to the off-system storage services that the
22 Company intends to provide through expansion of Troy Grove?

1 A. No. Actually, the illustration is generic in nature. Any gas utility that has more
2 than one pipeline supplier, together with storage capacity, could at least
3 theoretically operate its system in a manner that would match Mr. Iannello's
4 illustration and result in increased costs to customers. However, Mr. Iannello's
5 illustration does not describe displacement, as the Company uses that term to
6 describe the switching of gas supplies between storage and sendout, but rather a
7 shifting of purchases.

8 Q. Is it in the best interest of an Illinois gas utility to shift purchases in the manner
9 suggested by Mr. Iannello's illustration?

10 A. Absolutely not. Shifting purchases in such a manner would violate 83 Illinois
11 Administrative Code Part 525.40 (d), which expressly prohibits a utility from
12 entering into transactions that would raise gas charges. The Commission could
13 and should disallow the costs of any such transactions, and the utility would not
14 be able to recover the cost from customers.

15 Q. Nicor Gas currently has a Performance Based Ratemaking ("PBR") mechanism in
16 place which provides that its gas supply purchases are not subject to a traditional
17 prudence review by the Commission. Is there an incentive under the PBR for the
18 Company to increase gas supply costs in the manner illustrated by Mr. Iannello?

19 A. Definitely not. The purpose of the PBR is to provide Nicor Gas with an incentive
20 to reduce gas supply costs and for the Company to share in a portion of that
21 reduction as compared to a market-based benchmark. Obviously, if Nicor Gas
22 acted in the manner described in Mr. Iannello's illustration, thereby increasing its
23 gas supply costs, it would automatically reduce shareholder benefits under the

1 PBR. Thus, whether a utility is operating under a PBR or under 83 Illinois
2 Administrative Code Part 525, there is no economic incentive to increase
3 customers' gas supply costs.

4 Q. Do you believe that the example shown on Mr. Iannello's illustration for
5 displacement transactions is valid?

6 A. No. First, as I stated earlier, Mr. Iannello's illustration is what I would
7 characterize as a shifting of purchases and not displacement.
8 Second, Mr. Iannello uses a relatively wide range of numbers for the cost of gas
9 supply from three separate sources which I believe is inappropriate. However, I
10 do agree with Mr. Iannello's statement (page 16, lines 283-284) that, "...the
11 market for natural gas is competitive, and competitive markets tend to eliminate
12 arbitrage opportunities..." Therefore, any price opportunities would be
13 eliminated quickly by the market itself.
14 The third problem with Mr. Iannello's illustration is his simplification that
15 "Pipeline A" is connected to a storage field and, apparently, to nothing else, while
16 "Pipeline B" is not connected to any storage field. The facts are that the two
17 pipelines that are directly connected to Troy Grove, NGPL and Northern Border
18 Pipeline, are connected to Nicor Gas at several other points. Therefore, the
19 situation postulated in Mr. Iannello's illustration, that deliveries from an off-
20 system storage customer will force Nicor Gas to reduce its purchases on a
21 relatively low cost pipeline, is virtually certain not to occur.
22 Finally, Mr. Iannello's illustration assumes a "fixed pie" for deliveries over one
23 pipeline. It assumes that if a customer chooses to deliver gas on "Pipeline B"

1 Nicor Gas must decrease its volumes delivered on "Pipeline B" (scenario 2, page
2 13). This is simply not the case, as I have shown on Rebuttal Exhibit AEH-3.

3 **III. Potential Subsidization of Off-System Storage Service**

4 Q. Staff witness Iannello suggests that on-system customers could potentially
5 subsidize off-system storage service that would result from expanding Troy
6 Grove. Would you please comment?

7 A. In my opinion, the potential for cross-subsidization simply does not exist, as Mr.
8 Iannello fails to credibly explain just how the Company would be able to use "the
9 flexibility of on-system storage capacity that rate payers pay for through base
10 rates, to lower the cost and provide additional services to off-system customers."
11 (Iannello direct testimony, at 10) In fact, the Troy Grove expansion would
12 provide only a finite amount of capacity. These sales could be easily tracked by
13 the Commission. Additionally, the Company must charge enough for off-system
14 storage service to recover all costs allocated to the project or it would lose money
15 in providing the service. Since the Company's accounting proposal is to record
16 associated revenues and expenses, including those allocated from utility services,
17 below the line, the Commission should have no trouble reviewing the associated
18 revenues and costs.

19 Q. Does this complete your rebuttal testimony?

20 A. Yes.

Troy Grove Costs

	Existing	Expansion	Total
<u>O&M</u>			
Joint -			
Supervision	236,024		236,024
Compressor operations - general	178,541		178,541
Storage well readings, maintenance	131,068		131,068
Storage station activities	93,697		93,697
Training	88,447		88,447
Storage environmental	52,584		52,584
Fleet	52,232		52,232
Gas conditioning consumables	37,809		37,809
Gas conditioning maintenance	25,831		25,831
Storage gathering lines	15,636		15,636
Compressor consumables	8,051		8,051
Other	3,080		3,080
	<u>923,000</u>		<u>923,000</u>
Allocation to non-utility	(92,300)	92,300	-
	<u>830,700</u>	<u>92,300</u>	<u>923,000</u>
Direct -			
Compressor maintenance & repair by unit	138,291	65,000	203,291
Gas conditioning maint & repair by unit	38,692	10,000	48,692
Fuel (est)	1,000,000	250,000	1,250,000
Other	17		17
	<u>1,177,000</u>	<u>325,000</u>	<u>1,502,000</u>
	<u>2,007,700</u>	<u>417,300</u>	<u>2,425,000</u>
<u>Overheads</u>			
Joint -			
Depreciation on facilities/equipment	1,300,000		1,300,000
Return on rate base	1,150,000		1,150,000
Insurance	150,000		150,000
Depr on furn, tools, comp equip/software	70,550		70,550
Payroll taxes	63,750		63,750
Administrative support	60,350		60,350
Real estate taxes	52,000		52,000
Employee benefits	11,900		11,900
Rounding	(8,550)		(8,550)
	<u>2,850,000</u>		<u>2,850,000</u>
Allocation to non-utility	(285,000)	285,000	-
	<u>2,565,000</u>	<u>285,000</u>	<u>2,850,000</u>
Direct -			
Depreciation	960,000	900,000 a	1,860,000
Return on rate base	790,000	n/a	790,000
	<u>1,750,000</u>	<u>900,000</u>	<u>2,650,000</u>
	<u>4,315,000</u>	<u>1,185,000</u>	<u>5,500,000</u>
<u>Capital Expenditures</u>			
Base costs		26,000,000	26,000,000
Construction overheads	(4,000,000)	4,000,000 b	-
	<u>(4,000,000)</u>	<u>30,000,000</u>	<u>26,000,000</u>

a - On full \$30 million, including construction overheads.

b - Note that construction overheads allocated to non-utility expansion project would have likely been allocated to other utility capital projects in rate base. Thus, the ratepayer will be burdened with lower depreciation (\$164,000 at 4.1%) and return on rate base (\$386,800 at allowed 9.67%) related to the \$4,000,000 allocation.

Calculation of Benefits to Ratepayers

Reduction in Construction Overheads

Investment	\$	4,000,000
Annual Depreciation Expense	\$	164,000
Rate of Return at 9.67 %	\$	386,800

Reduction in Operation and Maintenance Expense

Common Costs at 10 %	\$	377,300
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Total Benefits to Ratepayers	\$	928,100
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Nicor Gas Proposals

Alternative 1:	Reduces Revenue Requirements	\$	928,100
Alternative 2:	Refund to Customers Immediately through the PGA	\$	1,000,000

Gas Supply Operations via Displacement**Scenario 1 - No Off System Sales Involving Utility Storage Field**

(Total Cost to Sales Customers = \$350 + \$250 + \$300 = \$900)

	<u>Pipeline A*</u>	<u>Pipeline B</u>	<u>Pipeline C</u>	<u>Total</u>
Deliveries from Off-System Customer	-	-	-	-
Deliveries for Sales Customers	1,000	1,000	1,000	3,000
Physical Flow				
Delivered to Customers	200	1,000	1,000	2,200
Delivered to Storage	800	-	-	800
Cost of Supply (per therm)	\$ 0.35	\$ 0.25	\$ 0.30	
Cost to Sales Customers by Supply Source	\$ 350.00	\$ 250.00	\$ 300.00	\$ 900.00

Scenario 2 - Off System Sales Involving Utility Storage Field

(Total Cost to Sales Customers = \$350 + \$250 + \$300 = \$900)

	<u>Pipeline A*</u>	<u>Pipeline B</u>	<u>Pipeline C</u>	<u>Total</u>
Deliveries from Off-System Customer	-	200	-	200
Deliveries for Sales Customers	1,000	1,000	1,000	3,000
Physical Flow				
Delivered to Customers	-	1,200	1,000	2,200
Delivered to Storage	1,000	-	-	1,000
Cost of Supply (per therm)	\$ 0.35	\$ 0.25	\$ 0.30	
Cost to Sales Customers by Supply Source	\$ 350.00	\$ 250.00	\$ 300.00	\$ 900.00

* Connected to storage field